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In the Zone: Fiduciary Duties and the Slide Towards Insolvency*

Andrew Gold, Sidney Swinson, and Ivan Reich

MR. REICH: Good afternoon. My name is Ivan Reich. I am with Becker and Poliakoff in Ft. Lauderdale.

We have materials in here that are rather extensive, and, today, we are talking about a concept known as deepening insolvency. At its core, the concept—and I use the word "concept" to mean that it is a theory, and we are going to discuss today whether it is really a cause of action or what it really is. Deepening insolvency is when a company enters what is known as the zone of insolvency, there is a theory developing, or has been developing, that the fiduciary duties are shifted from the shareholders to the creditors.

We have got to start with the fundamental duty of a corporation, and that is to maximize the value of the equity to the shareholders of the corporation. And there has become this trend that started that nobody has been really able to get their hands on that has developed over the years.

So one of the things we are going to do today is we are going to start off talking about what is deepening insolvency. Is it an independent tort cause of action? Is it really just another name for existing traditional causes of action that we already know? Is it a theory of damages? Does it exist even at all? Should it exist at all?

We are then going to get into the issues of who are some of the potential target defendants. What are some of the defenses who are available? We are going to talk about issues of standing; and, as you will see from the discussion today, that the issue of standing is critical when discussing deepening insolvency. Who really owns the cause of action? Should one exist?

We will also conclude at the end with some advice on how to avoid liability for those of you who are in business or advising businesses. These are things that those businesses could do to avoid having a lawsuit brought against them, as well as for those of you who are profes-

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sionals or soon-to-be professionals, in the case of law students who are here, what you can do to protect yourself from getting sued under one of these theories, as well.

I start my materials if you look with a quote from the musical *Monty Python's Spamalot.*[1] It was based upon the movie *Monty Python and the Holy Grail.*[2] Remember the guy who keeps saying, "I'm not dead yet"?[3] That is what this is about. Do we keep the company on life support to prolong it? Is there a value to keeping it alive? Or is it, maybe, in everybody's best interest to pull the plug? And at what point do you do it?

That is really where this comes down to. And, as you will hear from the panel, there is an overriding theory that not only do you have the duty to maximize the value of the shareholders—and the duty to shareholders is the preeminent duty of the board of directors—but the board of directors operates under the concept of the business judgment rule. And that should be the standard. From that background is where the law has developed.

The first case that really recognized this concept in any real form is called *Bloor v. Dansker*, which is *In re Investors Funding Corp. Securities Litigation.*[4] It is in the material. And this is where the concept first developed. It was a 1980 case out of the Southern District of New York.[5] "A corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it."[6] So what the *Bloor* Court said, and all it said, was that prolonging a debtor's corporate life was not necessarily a benefit. It did not say that it was harmful, but merely that it was not necessarily a good thing for the corporation.

The first case where the concept developed that it actually was deemed a harm is a case out of the Seventh Circuit, where you clerked, right?

MR. GOLD: Right.

MR. REICH: That is the case of *Schacht v. Brown.*[7] It is a 1983 case where the Seventh Circuit concluded that not only was prolonging a failing corporation's life not beneficial, it actually was a harm.[8] And

1. MONTY PYTHON'S SPAMALOT (Boyett Ostar Productions 2005).
2. MONTY PYTHON AND THE HOLY GRAIL (Michael White Productions 1975).
3. *Id.*
4. Bloor v. Dansker (*In re* Investors Funding Corp. of N.Y. Sec. Litig.), 523 F. Supp. 533 (S.D.N.Y. 1980).
5. *Id.*
6. *Id.* at 541.
7. Schact v. Brown, 711 F.2d 1343 (7th Cir. 1983).
8. *Id.*

the quote from the Seventh Circuit is "the corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability."[9]

Now from that concept has developed various theories on this deepening insolvency. And the first real case that came out where the concept that deepening insolvency was an independent tort is a famous case from the Third Circuit called *Lafferty*.[10] It is from this case from where this whole body of deepening insolvency has taken off.

At this point—and we are dealing with the issue now is the development of the concept as an independent tort—I am going to turn to Sid to take it from there.

MR. SWINSON: *Lafferty*[11] is particularly noteworthy because it is the first circuit court—federal circuit court—that addressed the issue of deepening insolvency.

Lafferty[12] was, like many of these cases, was a Ponzi scheme. It was an entity that joined itself with another entity that ultimately turned out to be a Ponzi scheme. And when the music stopped, the money stopped coming in. Those of you who do not know, a Ponzi scheme is an enterprise in which the way of funding subsequent, past investments is through new money, and so you do not have—you have a mere semblance of a business organization, and you are literally robbing Peter to pay Paul. You get money from later investors to pay earlier investors, who get exorbitant rates of return, and then get all excited and get more investors to invest. And it is fine as long as the investors keep coming in, but, when the music stops, it is really ugly.

And in the *Lafferty*[13] case, the music stopped at some point in time. Chapter Eleven[14] bankruptcy was filed by the debtor, and a bankruptcy trustee was appointed to replace the bad guys.[15] Like many Chapter Eleven[16] bankruptcy cases, there was a creditors committee appointed.[17] At some point in time, the decision was made that they wanted to put the blame where it belonged, and that is on the officers and directors and the principals of the company, and, to some extent, the professionals and financial advisors who helped facilitate the

9. *Id.* at 1350.

10. Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001).

11. *Id.*

12. *Id.*

13. *Id.*

14. 11 U.S.C. §§ 1101-74 (2006).

15. *Lafferty*, 267 F.3d 340.

16. §§ 1101-74.

17. *Lafferty*, 267 F.3d 340.

wrongdoing.[18] That included attorneys, accountants, and even the underwriter.[19] Lafferty was an underwriter,[20] if I recall correctly. They issued debt securities and it was underwritten by Lafferty.[21]

But what is important about the *Lafferty* case, as Ivan said, the holding of the case is that the Third Circuit had to make the decision about whether they were interpreting Pennsylvania law.[22] It was a federal court looking to interpret state law.[23] The Supreme Court of Pennsylvania at the time had never decided, or even a lower court in Pennsylvania had never decided, whether or not deepening insolvency existed as an independent distinct cause of action.

So the Third Circuit went through an analysis. In doing so, they justified recognizing deepening insolvency as an independent cause of action for three reasons. One is they said that extending the life of a corporation beyond insolvency seems like something that ought to be actionable, number one.[24] Number two is that they noted that there were other courts, lower courts, that had seemed to recognize this concept of deepening insolvency.[25] And, third, and most interestingly, is they said that there is kind of a general principle of court law, which is recognized in Pennsylvania, that where there is an injury, there ought to be a remedy.[26] And, doggone it; it look likes this is a real injury so we are going to find a remedy.[27]

But they did that without really going into a discussion of why they felt like they had to do so because the complaint itself—the complaint itself alleges the following causes of action: fraud, negligent misrepresentation, breach of fiduciary duty, and malpractice.[28] These are the kinds of causes of action that we know and we understand; but, nevertheless, the Third Circuit went into this analysis of deepening insolvency and came up with this notion that it is an independent cause of action.[29]

The opinion is interesting for a couple other points, one of which we will defer until later. The first being the standing issue, and that is that the committee of unsecured creditors in the bankruptcy case was em-

18. *Id.*
19. *Id.*
20. *Id.*
21. *Id.*
22. *Lafferty*, 267 F.3d 340.
23. *Id.*
24. *See id.*
25. *See id.*
26. *See id.*
27. *See Lafferty*, 267 F.3d 340.
28. *Id.*
29. *Id.*

powered by the court by stipulation to bring this cause of action.[30] And the thought was, well, is this a cause of action being brought by creditors or is this the right of a debtor that is being brought by the creditors committee for the benefit of the debtor? And the holding was that the cause of action itself belongs to the corporation, and it is brought by the creditors committee derivatively on behalf of the debtor for the benefit of all the creditors.[31] And the reason that is important is for this last point that we will defer until later, and that is—is that an action brought derivatively for the corporation is subject to the potential defense of *in delicto*, *in pari delicto*, meaning at equal fault. And the potential defendant could say, you know, you, plaintiff-corporation, regardless of what you look like now, you cannot bring a cause of action against me because you were at equal fault. Therefore, as a matter of equity, you cannot recover against me.

With that in mind, that provided the foundation, if you will, for other courts to expand into this new-found doctrine of deepening insolvency—a 2001 case.

MR. REICH: Now what ended up happening from *Lafferty*[32] around the country, but primarily in the Third, because the courts in the Third felt that they were compelled to follow *Lafferty*,[33] and that is where these cases started developing. For those of you who practice in the Third, you started seeing independent causes of action developing.

I want to come back to a point that Sid raised.

MR. SWINSON: Let me just say, this happens oftentimes in bankruptcy courts. You are going to see a lot of lower courts being bankruptcy courts—

MR. REICH: —finding themselves bound. Whether they like it or not, they are starting to find it.

But it comes back to a principle that you need to understand. In this country, there is no statutory basis for the concept of deepening insolvency. In England and Australia and several other countries, common law countries, there are statutory bases of deepening insolvency, actually a statutory cause of action. Here, this is all common law based.

In addition, there is no such thing as federal common law in the area of deepening insolvency other than the fact people feel compelled to follow the precedent laid down by these federal courts. Everything is based upon state tort law.

30. *Id.*
31. *Id.*
32. *Lafferty*, 267 F.3d 340.
33. *Id.*

MR. SWINSON: It is worse than that. It is based upon what these federal courts think state law is. Really, it is.

MR. REICH: It is because that is what is happening. That is where *Lafferty*[34] really goes. And we were talking about this beforehand. *Lafferty*[35] should have certified it back to the Pennsylvania Supreme Court. I mean, that really would have been the right thing to have been done; but, instead, they opined what they thought Pennsylvania would do.

Now what you are looking at, whether you are either on the plaintiff's or the defendant's side, your first defense is going to be failure to state a cause of action. In this particular case, you have got to look where you are at. And the courts have been all over the place around the country, but most of the cases that have found such a cause of action have been in the Third Circuit.

Now something happened fairly recently in the Third Circuit, and why don't you tell us about that?

MR. SWINSON: There is a 2006 case called the *CitX* case, a case out of the Third Circuit where the issue of deepening insolvency came up again.[36] And I point out that of the three judges on the panel in the *Lafferty* case,[37] one of those judges and the author of the opinion was a person named Fuentes. Fuentes was also on the panel in the *CitX Corporation* case.[38] It came up before the Third Circuit, and, in this particular case, it was what appeared to be a more traditional situation where there was a failed business that relied heavily, at least for credit, on a financial statement given by an accountant, a particular accountant in the accounting firm, and the financial statement was just lousy.[39]

There were two entities involved here, and the one entity that had the bad financial statement; the financial statement was bad because it relied upon the value of a receivable from this related company, that they overstated its value, and, therefore, made the corporation appear to be solvent when, in fact, it was hopelessly insolvent because this receivable from the related company was worthless.[40]

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34. *Id.*

35. *Id.*

36. Seitz v. Detweiler, Hershey and Associates, P.C. (*In re* CitX Corp.), 448 F.3d 672 (3d Cir. 2006).

37. *Lafferty*, 267 F.3d 340.

38. *CitX Corp.*, 448 F.3d 672.

39. *Id.*

40. *Id.*

And, so, once bankruptcy was filed, a lawsuit was brought on the theory of deepening insolvency.[41] And five years later in the *CitX Corporation* case,[42] the judges of the circuit had an opportunity to tackle this thing again. They obviously could not retreat from where they were on *Lafferty*[43] because that was the law at the time and they were not sitting en banc; and so they had to reluctantly recognize that deepening insolvency was a valid theory of recovery, but they refused to go one step further and recognize deepening insolvency as a measure of damages.[44]

So the court held that there were causation problems.[45] They would say you cannot just simply rely on this notion that, because the company got more insolvent, that that is the measure of damages that are available if there is a valid cause of action. They refused because of that to find that there was causation.[46] And they said, if anything, this bad financial statement allowed this company to get more credit; it did not really jeopardize the company itself.[47] There may have been harm to creditors, but not to the company; and, therefore, there was no recovery against the accountant.[48]

And so that was a dramatic pullback by the Third Circuit[49] from what appeared to be a profound change from *Lafferty*.[50]

MR. REICH: What it did was—you have to remember, because the decision was not en banc, they could not overturn *Lafferty*[51] outright. But what this Third Circuit panel narrowed it down to—and there are several Pennsylvania lawyers in the back of the room, and you guys are stuck with it—was that to everybody else in the circuit, we are not saying that there is cause of action for deepening insolvency anywhere else, but all that we are saying that there is such a cause of action only in Pennsylvania because we could not really undo *Lafferty*;[52] but, also, we are merely limiting the cause of action to a negligence damage theory.

41. *Id.*
42. *Id.*
43. Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001).
44. *CitX Corp.*, 448 F.3d 672.
45. *Id.*
46. *Id.*
47. *Id.*
48. *Id.*
49. *CitX Corp.*, 448 F.3d 672.
50. Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001).
51. *Id.*
52. *Id.*

MR. SWINSON: Let me stress that again. Remember, in *Lafferty*,[53] it was basically fraud, breach of fiduciary duty, those types of causes of action which really served as the foundation for the deepening insolvency claim. Whereas, in the *CitX*[54] case, it was just malpractice, just negligence, simple negligence.

And, so, even though they concentrated on whether deepening insolvency can be a measure of damages, probably equally important holding from that case is that mere negligence alone may not be the basis for a deepening insolvency claim.[55] If we are stuck in the Third Circuit with a notion that deepening insolvency is an independent cause of action, it is in the event of fraud, but do not try to use it for mere negligence.

MR. REICH: What is interesting is, when we come back to that issue in a minute, and I want to not let go of that, but in *Lafferty*, because it was dismissed on an *in pari delicto* theory, the court said, yeah, there is a cause of action for it, but never actually got around to establishing what the elements of that cause of action were.[56]

MR. SWINSON: Which leads you to wonder if it is only applicable in a context of fraud, which is you have got to prove intent to defraud, which is difficult to do, much more difficult than mere negligence. If it is not an independent—even if it is an independent cause of action based upon fraud, how does it help you any? How does it really help the plaintiff to try to prove a case? I am not sure I understand that.

MR. REICH: In fact, in the materials that you have, there is a section on here, whether negligence is enough or whether it has to be fraud. And I am just going to cite to you guys the case of *Oakwood Homes Corp.*[57] All of the cited cases in the materials stand for the concept that you need at least fraud; negligence will not do it. Those cases are *Oakwood Homes Corp.* case;[58] *Student Finance Corp.*;[59] *Total Containment, Inc.*;[60] *Corporate Aviation Concepts, Inc.*;[61] and

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53. *Id.*

54. *CitX Corp.*, 448 F.3d 672.

55. *Id.*

56. *See Lafferty*, 267 F.3d 340.

57. OHC Liquidation Homes Corp. v. Credit Suisse First Boston (*In re* Oakwood Homes Corp.), 340 B.R. 510 (Bankr. D. Del. 2006).

58. *Id.*

59. Stanziale v. Pepper Hamilton LLP (*In re* Student Finance Corp.), 335 B.R. 539 (Bankr. D. Del. 2005).

60. Miller v. Marcel Dutil (*In re* Total Containment, Inc.), 335 B.R. 589 (Bankr. E.D. Pa. 2005).

61. Corporate Aviation Concepts, Inc. v. Multi-Service Aviation Corp., No. Civ.A.03-3020, 2005 WL 1693931 (E.D. Pa. July 19, 2005).

CitX.[62] All of these cases were very specific in their rulings that deepening insolvency should not be expanded to negligent acts.

But if you are in D.C., the case of *Greater Southeast Community Hospital, Corp.*;[63] if you are in New York, *Gouiran Holdings*;[64] and in New Jersey, *Crowley v. Chait*;[65] Ohio, *LTV Steel*;[66] in Florida, *Flagship Healthcare*.[67] All those cases say that mere negligence will do, and that deepening insolvency does not have to be founded on fraud.

What I am now going to do is shift because—

MR. SWINSON: And to reiterate a point: notice that those decisions are either federal court or bankruptcy court decisions. You are not seeing state courts ruling on what the law of the state is in those jurisdictions.

MR. REICH: That is right.

Now what I am going to do is we are now going to talk about some state court law. As we all know, for various reasons I do not need to reiterate, the preeminent state in the country for the development of corporate law is Delaware. Professor Gold is going to talk about the development of the deepening insolvency concept under Delaware law, which is indicative of the national trend starting with *Credit Lyonnais*[68] up to the very important *Trenwick* decision,[69] which just came down recently. As you will see, there have been some very recent rulings that have now followed *Trenwick*,[70] and I suspect *Trenwick*[71] may be the wave of the future as to where the law is going in deepening insolvency. Professor Gold.

MR. GOLD: First off, the issues here I think go really to the core of fiduciary duty. And there is a famous quote from Justice Frankfurter where he says it is not enough simply to know someone is a fiduciary, that he needs to know to whom they owe fiduciary duties and what

62. Seitz v. Detweiler, Hershey and Associates, P.C. (*In re* CitX Corp.), 448 F.3d 672 (3d Cir. 2006).

63. Alberts v. Tuft (*In re* Greater Se. Cmty. Hosp. Corp. I), 353 B.R. 324 (Bankr. D.D.C. 2006).

64. Gouiran Holdings, Inc. v. DeSantis, Prinzi, Springer, Keifer & Shall (*In re* Gouiran Holdings, Inc.), 165 B.R. 104 (Bankr. E.D.N.Y. 1994).

65. Crowley v. Chait, 322 F. Supp. 2d 530 (D.N.J. 2004).

66. *In re* LTV Steel Co., 333 B.R. 397 (Bankr. N.D. Ohio 2005).

67. Tabas v. Greenleaf Ventures, Inc. (*In re* Flagship Healthcare, Inc.), 269 B.R. 721 (Bankr. S.D. Fla. 2001).

68. Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., No. Civ. A. No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

69. Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168 (Del. Ch. 2006), *aff'd sub nom.* Trenwick Am. Litig. Trust v. Billett, No. 495, 2007 WL 2317768 (Del. Aug. 14, 2007).

70. *Id.*

71. *Id.*

kind of duties they are.[72] And I think that that is largely what the Delaware courts have been struggling with here and how that fits in with the business judgment rule.

The *Credit Lyonnais* case is a 1991 decision by Chancellor Allen.[73] The facts are somewhat complex, and I am going to focus on the holdings here. But in that case, Chancellor Allen suggests that fiduciary duties, in some context, are not going to just be owed to shareholders.[74] Instead, the duties can, in some circumstances, be owed to the larger corporate enterprise.[75] His language is, he says, "At least where a corporation is operating in the vicinity of insolvency, the board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise."[76]

And that language, in this circumstance, allowed the board to take into account creditor interests in reaching its business decisions. The idea would be that when you are in the zone of insolvency or when the company has actually gone into insolvency, that the major claimants on a company are the company, rather than the shareholders, and that it would be appropriate for the board to think about that, to take that into account.

But, at the same time, the use of this language here was a defensive use.[77] This is a circumstance where recognition of creditor interests was used as a shield to protect the board in its business choice and allow it to think of a larger corporate enterprise, rather than solely shareholders.[78] It is not a case that actually endorses a deepening insolvency theory or a direct creditor claim or something of that nature.

Nevertheless, the language is a little bit vague, and there is a footnote there where Chancellor Allen's discussion of the duties is relatively broad.[79] And so *Credit Lyonnais*[80] has been a starting point for some theories of creditor-based claims in Delaware.

The next step, the next significant step in Delaware cases is a case called *Production Resources*.[81] This one is a decision by Vice Chancellor Strine, a 2004 decision.[82] And here we see something of a pullback

72. Sec. and Exch. Comm'n v. Chenery Corp., 318 U.S. 80, 85-86 (1943).
73. *Credit Lyonnais*, 1991 WL 277613.
74. *See id.*
75. *See id.*
76. *Id.* at *34.
77. *See id.*
78. *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., No. Civ. A. No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991).
79. *Id.* at *34 n.55.
80. *Id.* at *1.
81. Prod. Res. Group, L.L.C. v NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004).
82. *Id.*

from a broader creditor-based plan. Vice Chancellor Strine is thinking in terms of the business judgment rule and its applicability here, and he also is thinking in terms of Section 102(b)(7)[83] of the Delaware code.[84] And 102(b)(7) is a provision that allows exculpatory provisions within a corporation's charter.[85] So it allows for a corporate board to be protected from due-care-based plans for monetary damages, and Strine suggests that those provisions can apply in cases where the claimants initiate the action.[86] So there is some protection from a due care type of claim here, and, also, he gives a strong endorsement of the business judgment rule.[87]

The next step is another Strine opinion, and that is the 2006 *Trenwick* decision.[88] Here, Vice Chancellor Strine is squarely faced with the idea that there could be an action for a deepening insolvency, and his answer is that there definitely is not.[89] He explicitly says that Delaware did not recognize an independent cause of action for deepening insolvency.[90] In his view, that would be analogous to having an action for shallowing profitability.[91]

So the concept here is pretty much dead at the lower court level in Delaware, and the question is whether that represents Delaware law. *Trenwick*[92] itself, I understand, is on appeal,[93] and it would certainly be nice to have a Delaware Supreme Court case here. We may ultimately find out if Strine's theory wins.

MR. REICH: What is interesting is before *Production Resources*[94] sort of pulled this back, there was a case out of the Delaware bankruptcy court called the *Official Community of Unsecured Creditors v. Fleet Retail*, also known as *In re Hechinger Investment Company of Delaware*.[95] That case jumped on the initial *Credit Lyonnais*[96] theory.

83. DEL. CODE ANN. tit. 8, § 102(b)(7) (2006).

84. *See Prod. Res.*, 863 A.2d 772.

85. § 102(b)(7).

86. *See Prod. Res.*, 863 A.2d 772.

87. *See id.*

88. Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168 (Del. Ch. 2006), *aff'd sub nom.* Trenwick Am. Litig. Trust v. Billett, No. 495, 2007 WL 2317768 (Del. Aug. 14, 2007).

89. *Id.*

90. *Id.*

91. *Id.*

92. *Id.*

93. After the Symposium, the Delaware Supreme Court affirmed both the holding and reasoning of the Court of Chancery in *Trenwick*. Trenwick Am. Litig. Trust v. Billett, No. 495, 2007 WL 2317768 (Del. Aug. 14, 2007).

94. Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004).

95. Official Comm. of Unsecured Creditors of Hechinger Inv. Co. of Del. v. Fleet Retail Fin. Group (*In re* Hechinger Inv. Co. of Del.), 274 B.R. 71 (Bankr. D. Del. 2002).

Now remember, *Credit Lyonnais*—and I know I am botching my French for you French speakers here—as Professor Gold said, was merely a shield.[97] It was a defensive case.[98] That case actually used it as a sword.[99] It was kind of—it was the bankruptcy courts in Delaware, just like Strine said, looking at what Delaware courts said. They already went so far to allow it defensively, why do we not now allow it to be used offensively?

MR. SWINSON: And I think it was a Ponzi scheme, wasn't it?

MR. REICH: I think so. Again, now subsequent to that decision, *Production Resources*[100] had pulled it back somewhat relying on Section 102[101] a lot. Now, *Trenwick*[102] has really pulled it way back.

MR. GOLD: I would agree with that. I also think that some of the language in Strine's opinions gives you some insights as to why the Delaware courts are reaching some of these recent decisions.

If you think about what the business judgment rule does and why it works, one of the difficulties that boards have in reaching business decisions is figuring out what constituency to look out for and, also, what is going to be in the best interest of the company. When you are dealing with insolvency, with a zone of insolvency, you have what Professor Bainbridge has called a two-master problem.[103] If boards are supposed to look out for shareholders and also supposed to look out for creditors, they are in a very awkward spot because, whichever side they choose, they may end up, if they favor one side, being sued by the other side.[104] And so, as you go into this area of insolvency and as you end up with potentially conflicting fiduciary duties, the business judgment rule becomes especially important.

Another feature of, what is going on here, is the problem of hindsight bias. Courts are concerned that they will make errors when they try to assess a board's decision-making after the fact. A perfectly good decision at the time may look very foolish in retrospect if it did not work. And when you are dealing with companies that have gone into

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96. Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., No. Civ. A. No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

97. *Id.*

98. *Id.*

99. *Hechinger*, 274 B.R. 71.

100. Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004).

101. DEL. CODE ANN. tit. 8, § 102 (2006).

102. Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168 (Del. Ch. 2006), *aff'd sub nom.* Trenwick Am. Litig. Trust v. Billett, No. 495, 2007 WL 2317768 (Del. Aug. 14, 2007).

103. Stephen M. Bainbridge, *Much Ado About Little? Directors' Fiduciary Duties in the Vicinity of Insolvency*, J. BUS. & TECH. L. (forthcoming), *available at* http://ssrn.com/abstract=832504.

104. *Id.*

insolvency, it is often going to look like a business decision was a poor one.

The Delaware courts' response is that they want to be especially cautious there not to second-guess. And so I think those policy reasons, to some degree, inform what is happening here.

MR. SWINSON: And who wants to be on a corporate board if they are going to be subject to second-guessing? I mean, really?

MR. GOLD: I agree.

MR. REICH: What is interesting is since *Trenwick*[105] came out, some recent decisions have followed. In my mind, the most significant one is one out of the Seventh District of Ohio. We got some Ohio practitioners on this side of the room. It is called *Amcast Industries, Corp.*[106] It is 2007 Westlaw 777704; it was entered on March 12, 2007.[107] And in that case, Judge Walter—in my mind writes one of the best opinions out there, in which he basically adopts *Trenwick*[108] as a whole.[109] And it is a fantastic decision. Some of the language in there is *Trenwick*-based language, but it basically develops what I think is almost a fourth line of cases and approach.

We are talking about those who say there is a cause of action, and there are those cases that say it is just another name for an existing tort. There are others that say it is a measure of damage. And now, there is this *Trenwick*[110] trend, which is basically saying there is no such thing as deepening insolvency altogether, and that really the business judgment rule prevails. And that is what *Amcast*[111] says.

You are now starting to see, since *Trenwick*,[112] in that short time, since August, this trend developing.

MR. GOLD: August 2006.[113]

MR. REICH: All the cases are starting to come out are citing *Trenwick*[114] and are starting to go in that direction.

105. *Trenwick*, 906 A.2d 168.

106. Liquidating Tr. of the Amcast Unsecured Creditor Liquidating Trust v. Baker (*In re* Amcast Indus. Corp.), 365 B.R 91 (Bankr. S.D. Ohio 2007).

107. *Id.*

108. 906 A.2d 168.

109. *Amcast*, 365 B.R. 91.

110. 906 A.2d 168.

111. *Amcast*, 365 B.R. 91.

112. Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168 (Del. Ch. 2006), *aff'd sub nom.* Trenwick Am. Litig. Trust v. Billett, No. 495, 2007 WL 2317768 (Del. Aug. 14, 2007).

113. *Id.*

114. *Id.*

MR. SWINSON: Realistically, when will we likely see a decision on *Trenwick*,[115] do you know?

MR. GOLD: I cannot predict. I do not think that the Delaware Supreme Court usually takes that long, but I do not know.[116]

MR. REICH: Well, as we talked about before, there are cases which talked about the negligence theory.

The second area that had developed after *Lafferty*,[117] stating that deepening insolvency was a cause of action, was a response in which a lot of courts were saying, wait a second, we buy the concept, but not as an independent tort. Those courts started to find that there are other torts out there that deal with the same concept, primarily through breach of fiduciary duty claims. And that is the one that they most focus on.

You got cases out there like the *Parmalat* Case;[118] *Greater Southeast Community Hospital*;[119] *James River Coal*,[120] which is a very recent case out of the bankruptcy court of Eastern District of Virginia, and actually, in my mind, the best written opinion on this theory. And the judge is Judge Huennekens.[121] Actually, it is a great decision which espouses the theory that you can bring this as a plaintiff if you are trying to espouse the deepening insolvency concept through an aiding and abetting a breach of fiduciary duty claim. I do not particularly believe in it, but if you are in one of those jurisdictions that believe in the separate tort theory, aiding and abetting, if your state recognizes it, for example. My state[122] does not recognize aiding and abetting liability of breach of fiduciary duty or conspiracy theories.

MR. BILL SCHORLING: Delaware does.

MR. REICH: Delaware does. Again, this comes back to litigating it in the bankruptcy courts because that is where they tend to arise, but they really are fundamentally state court issues. So where you are

115. *Id.*

116. After the Symposium, the Delaware Supreme Court affirmed both the holding and reasoning of the Court of Chancery in *Trenwick*. Trenwick Am. Litig. Trust v. Billett, No. 495, 2007 WL 2317768 (Del. Aug. 14, 2007).

117. Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001).

118. Bondi v. Bank of Am. Corp. (*In re* Parmalat Sec. Litig.), 383 F. Supp. 2d 587 (S.D.N.Y. 2005).

119. Alberts v. Tuft (*In re* Greater Se. Cmty. Hosp. Corp. I), 353 B.R. 324 (Bankr. D.D.C. 2006).

120. Schnelling v. Crawford (*In re* James River Coal Co.), 360 B.R. 139 (Bankr. E.D. Va. 2007).

121. *See id.*

122. Flordia.

bringing your action or where you are defending your action, you have to look at the development of this theory under that state's law.

Conspiracy. Traditional lender liability. I want to talk for a minute about the *Exide* case.[123] I do not know how many of you are familiar with *Exide*.[124] Let me get it. There is *Exide*.[125] There is *Global Service Group*,[126] and there is the *Parmalat* case.[127] And *Exide*[128] was one of those cases that actually found deepening insolvency cause of action. This is in bankruptcy court in the District of Delaware again.[129] There was this period before *Production Resources*[130] where the bankruptcy courts in Delaware started getting really active on this cause of action. But they actually found one not just against the board of directors, which is the most obvious target.[131] Here, they found it against the lender. A lender who had obtained control of the debtor used its control to prolong the debtor's life for two years and forced it to enter into transactions or delay a bankruptcy filing in order to favor the lender at the expense of the debtor.[132] That is the *Exide*[133] decision. It is 299 B.R. 732, 752.

On the other hand, subsequently, in a much more recent decision, there was a 2006 case out of Delaware, again, a Bankruptcy District Delaware case, *Oakwood Homes Corp.*, 340 B.R. 510, which held that simply lending to an insolvent corporation, without more, cannot possibly be a tort.[134] The Court found that encouraging lending to a troubled company can be a good thing, and not a tort.[135]

In fact, in the *Global Services* case out of the Southern District of New York, Bankruptcy Court, Southern District in 2004, said, this may be bad banking, but it is not a tort; and rejects a claim for deepening insolvency because the bank made a loan that it knew or should

123. Official Comm. Of Unsecured Creditors v. Credit Suisse First Boston (*In re* Exide Techs., Inc.), 299 B.R. 732 (Bankr. D. Del. 2003).

124. *Id.*

125. *Id.*

126. Kittay v. Atlantic Bank of N.Y. (*In re* Global Serv. Group, LLC), 316 B.R. 451 (Bankr. S.D.N.Y. 2004).

127. Bondi v. Bank of Am. Corp. (*In re* Parmalat Sec. Litig.), 383 F. Supp. 2d 587 (S.D.N.Y. 2005).

128. 299 B.R. 732.

129. *Id.*

130. Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004).

131. *Exide*, 299 B.R. at 752.

132. *Id.*

133. *Id.*

134. OHC Liquidation Homes Corp. v. Credit Suisse First Boston (*In re* Oakwood Homes Corp.), 340 B.R. 510 (Bankr. D. Del. 2006).

135. *See id.*

have known Global could never have repaid.[136] In North Carolina, in *Parmalat*, this is a New York case.[137] It is a Southern District New York case applying North Carolina law.[138] There is no separate cause of action for tort for deepening insolvency based on a lender's duty or borrower.[139] There is a whole body of case law out there on lender liability theory regarding what are your duties as a lender. However, that court, the *Parmalat* court, did caution, if officers and directors can be shown to have breached their fiduciary duties by deepening the corporation's insolvency and the resulting injury to the corporation is cognizable, that injury is compensable and a claim for breach of fiduciary duty may stand.[140] This case falls into that second group of cases that I talked about.

And because a third party who aides and abets a breach of fiduciary duty is liable under North Carolina law, such conduct would reach a cognizable claim suffered by the company by reasons of a deepened insolvency brought by the company insiders with the bank's assistance. What does that mean? The bank could be liable for aiding and abetting the officers and directors of breach of fiduciary duty. That is where the banks have exposure. If you are representing lenders in an *Exide*[141] situation, like most people when we advise them on lender liability issues, stay out of the domain of control.

One of the next issues that really comes out of this is there has been a third body of development—and, by the way, I just want to reel off a couple more theories for you to write down if you want to bring these causes of action: piercing the corporate veil with respect to accountants and lawyers for malpractice, general breach of corporate duties into your state corporation laws like breach of good faith, fair dealing, loyalty, care, conflict of interest, self-dealing, all those theories, fraud usually in the preparation of financial statements for reporting. And another interesting theory as a creditor is unfair trade practices under state and federal unfair trade practices statutes. All of these are theories that you can pursue as independent tort or common law or statutory-based tort theories that all in some ways have a sort of deepening insolvency component to it. This now leads me now into the third area

136. Kittay v. Atlantic Bank of N.Y. (*In re* Global Serv. Group, LLC), 316 B.R. 451 (Bankr. S.D.N.Y. 2004).

137. Bondi v. Bank of Am. Corp. (*In re* Parmalat Sec. Litig.), 383 F. Supp. 2d 587 (S.D.N.Y. 2005).

138. *Id.*

139. *See id.*

140. *Id.*

141. Official Comm. Of Unsecured Creditors v. Credit Suisse First Boston (*In re* Exide Techs., Inc.), 299 B.R. 732 (Bankr. D. Del. 2003).

where the case law has developed. And I am going to read you the quote again from the *Greater Southeast Community Hospital* case,[142] which is basically that it is a measure of damages. It is not a tort into itself. It is not even an independent tort. It is not even a tort. It is just a measure of damages under an existing body of tort law.

However, in the *CitX* case[143] and other cases—and I am going to let you comment, Sid, on this Oklahoma case called *Commercial Financial Services*,[144] which was actually one of those rare state court cases on the issue that does not come out of Delaware. Oklahoma held that they did not recognize the measure of damages for deepening insolvency.[145] There is a split, but there is much more case law going the other way that it is a theory of damages. So, I want to ask Sid to talk about it, and I want to ask Professor Gold, what are your thoughts about the deepening insolvency concept as really just a measure of damages for all those other independent torts that I just talked about?

MR. GOLD: Sure. I guess my take on it would be that if you otherwise are getting past the hurdles for a fiduciary claim in Delaware, that is certainly plausible that you could think of damages in those terms. But Delaware is being pretty clear that basing your claim on a deepening insolvency theory alone is not going to be adequate.

MR. REICH: What about the other causes of action that I reeled off before, the other independent causes of action?

MR. GOLD: Well, I think the self-dealing one is probably the most likely one based on some of the language that you see in cases like *Production Resources*.[146] If you can show—if you are able to bring the claim on behalf of the corporation, and you are able to show that there is self-dealing, you can get past the hurdles for duty of care claims so that the problem sounds in the duty of loyalty. I think that is something that might be recognized, and some of the language in *Production Resources*[147] could support that.

MR. SWINSON: You mean deepening insolvency as a measure of damages for that cause of action?

MR. GOLD: Well, if there is self-dealing, then the court is going to look to whatever damages ought to be. If deepening insolvency is an

142. Alberts v. Tuft (*In re* Greater Se. Cmty. Hosp. Corp. I), 353 B.R. 324 (Bankr. D.D.C. 2006).

143. Seitz v. Detweiler, Hershey and Associates, P.C. (*In re* CitX Corp.), 448 F.3d 672 (3d Cir. 2006).

144. Commercial Fin. Servs., Inc. v. J.P. Morgan Sec., Inc., 152 P.3d 897 (Okla. Civ. App. 2006).

145. *Id.*

146. Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004).

147. *Id.*

aspect of that, I certainly think you could point to that as evidence of harm.

MR. SWINSON: Does deepening insolvency aid the practitioner in measuring damages? I mean, is it needed?

MR. GOLD: I do not think it would be necessary.

MR. SWINSON: Anymore needed than deepening insolvency as an independent cause of action? Perhaps not.

You got to wonder what the motivation for coming up with this concept of deepening insolvency was. I mean, you like to think that, here we represent this body of potential claimants. We are looking for an easier, better way to build a mousetrap—think of a better way to bring a cause of action to prove our case and calculate damages.

But I just—I am not sure that I am personally convinced that this concept of deepening insolvency solves any of those goals. Even in *Lafferty*,[148] when you read it carefully, they talk—the Third Circuit talks about deepening insolvency being an independent cause of action, yet they do not explain what they did with all the claims that were actually pled in the complaint—breach of fiduciary duty, malpractice, fraud, all those sorts of things.

And, likewise, I have yet to see a court really explain really to my satisfaction how calculating the damages based upon this concept of deepening insolvency really makes the job a whole lot easier in any event.

MR. REICH: I see the trend going—I look at Judge Walker's decision out of Seventh District of Ohio in *Amcast*[149] as really, I think, where it is going. He takes as a starting point *Trenwick*,[150] and he accepts it wholeheartedly.[151] He adopts it completely.[152]

But he goes a little further because then he comes back to the concept and he says—and he accepts it as a damage theory.[153] He takes *Trenwick*,[154] but then says, while declining to recognize deepening insolvency as a valid cause of action, the court believes that the concept may be useful as a measure of damages for breach of fiduciary duty or

148. Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001).

149. Liquidating Tr. of the Amcast Unsecured Creditor Liquidating Trust v. Baker (*In re* Amcast Indus. Corp.), 365 B.R 91 (Bankr. S.D. Ohio 2007).

150. Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168 (Del. Ch. 2006), *aff'd sub nom.* Trenwick Am. Litig. Trust v. Billett, No. 495, 2007 WL 2317768 (Del. Aug. 14, 2007).

151. *See Amcast*, 365 B.R. 91.

152. *See id.*

153. *See id.*

154. *Trenwick*, 906 A.2d 168.

commission of an action of tort.[155] So he sort of adopts it, *Trenwick*,[156] but then he goes so far and says, as a measure of damages.[157]

I do not know where you guys think the law is going, but I think this sort of convergence of the independent tort with this measure of damages is probably where it is going, unless the pure *Trenwick*[158] concept of business judgment rule prevails, no matter what, is the trend where the law is going.

MR. SWINSON: But even in *Trenwick*,[159] isn't there room for a determination that, no, deepening insolvency is not an independent cause of action, but it might be a way to measure damages?

MR. REICH: Well, that is what I think Judge Walker said. I do not think *Trenwick*[160] said that. I think *Trenwick*[161] left that door open, but it suggested it. And that is where Judge Walker took it in that Ohio decision.

MR. SWINSON: You talked about—

MR. REICH: That is where I am going right now.

I think the area where there is probably even more confusion in the areas which we just talked about now is in the issue of standing. Who can bring this cause of action?

MR. SWINSON: This is interesting because, even in the *Lafferty* case,[162] they talked about standing. I think in *CitX*[163] they did as well.

But what is going on again is that this is not—this deepening insolvency is not a cause of action that the creditors own that they can bring themselves. The holding in those two cases[164] was that it is a cause of action that under state law belongs to the aggrieved party, the corporation. But then the issue is who can bring that.

Well, look at the practicalities of it. Let's put it in the context of a Ponzi scheme. I like to talk about these Ponzi schemes because so many of these things are in the Ponzi schemes. Before I get to that, I have got to give you a story. With the gas industry in the Oklahoma, maybe Oklahomans being the way they are, we get probably our lion's

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155. *See Amcast*, 365 B.R. 91.

156. *Trenwick*, 906 A.2d 168.

157. *See Amcast*, 365 B.R. 91.

158. *Trenwick*, 906 A.2d 168.

159. *Id.*

160. *Id.*

161. *Id.*

162. Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001).

163. Seitz v. Detweiler, Hershey and Associates, P.C. (*In re* CitX Corp.), 448 F.3d 672 (3d Cir. 2006).

164. The two cases are *Lafferty*, 267 F.3d 340 and *CitX*, 448 F.3d 672.

share of Ponzi schemes down there. Every decade or so we get a really good one.

And, recently in the bankruptcy court, there was a Chapter Eleven[165] filed for whatever; it was a Ponzi scheme. And a really bright, talented attorney who loves challenges represented the debtor in the case and went ahead and quickly filed a plan of disclosure statement and really pushed that case along. And they come up to a confirmation hearing and this attorney made this really nice presentation, trying to get his disclosure statement approved. And the judge was sitting there kind of absentmindedly, really just kind of wondering what he was thinking. And, after the attorney finished with his presentation, the judge said, Mr. Such-and-Such, this court does not confirm Ponzi schemes. That was the end of the case.

So with that in mind, based upon state law, the causes of action, whatever they are, belong to the corporation under state law. And under the bankruptcy code, a state law cause of action belongs to the bankruptcy state under Section 541.[166] It is a debtor asset for the debtor to prosecute. The problem is that in Chapter Eleven,[167] the debtor that got the organization into trouble in the first place gets to be this fiduciary that we call a debtor-in-possession; and, believe it or not, just because people are armed with this title, debtor-in-possession, does not mean they necessarily change their stripes. And that is why there are bankruptcy trustees appointed from time to time.

In these particular cases, the committee was designated with a responsibility of bringing the claims, whatever they were. And I think the practical reason for that is because, if a debtor-in-possession were bringing the claim, it is the *in pari delicto* defense looks so obvious because you have got the same people that committed the causes of action are the ones that are now prosecuting it with the white hats. It just does not work very well. So they like to have the trustees' or the creditors' committees bring these claims.

But what is particularly interesting about it is that they are subject to this *in pari delicto* defense. But what is almost counterintuitive to me on this theory, is that the duty belongs to the corporation and the shareholders for a solvent entity, but, yet, if an entity becomes insolvent or within the zone of insolvency, the duties are kind of shifted more towards the creditors.

165. 11 U.S.C. §§ 1101-74 (2006).

166. § 541.

167. §§ 1101-74.

These cases that address standing are saying, but the cause of action under state law belongs to the corporation. It is the corporation that has to bring it; but, yet, in the really bad situations where the creditors are being harmed, they are being harmed in a context of the insolvent entities, but, yet, they are not the ones empowered to do anything about it. And so it seems counterintuitive to me.

MR. REICH: Well, it goes back to the issue of duty. Who is the duty to? Is the duty to the shareholders, to the corporate body? Or is the duty to the creditor?

If you are in a situation where the duty is to the shareholders or the corporate body, then that is the party or the entity that has the standing. If you are in a court who has determined that the duty is to the creditors, then I say it is the creditor's cause of action. It is their standing.

MR. SWINSON: But the cases do not necessarily say that.

MR. REICH: The cases are all over the board. For example, in the *Oakwood Homes*[168] court case out of the bankruptcy court in Delaware in 2006, 340 B.R. 510, they agree with you. He says, under Delaware, New York, and North Carolina law, again as predicted by the bankruptcy court, fraud alleged must be harmed to the corporation and not to an individual corporate creditor—hence, the standing there.

MR. SWINSON: Now I agree that the cause of action should not belong to an individual creditor because the harm was done to everybody. So it ought to be—the cause of action ought to be able to be brought for the benefit of the entire creditor body.

MR. REICH: Wrong. I will tell you why. Because I had this in a case down in Florida, and this was the distinction: Why should a trustee on petition day—well, not even that. On the date the deepening insolvency occurred, let's forget petition day—

MR. SWINSON: As if you knew when that was?

MR. REICH: Let's say—you are going to have to prove it at some point when that started. January first, you determined, is the date that the slide occured. You enter that zone of insolvency. All right?

MR. SWINSON: He has got a smirk on his face.

MR. REICH: I am the creditor. I have already been a creditor. I owe three million dollars.

MR. SWINSON: Lucky you.

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168. OHC Liquidation Homes Corp. v. Credit Suisse First Boston (*In re* Oakwood Homes Corp.), 340 B.R. 510 (Bankr. D. Del. 2006).

MR. REICH: How am I harmed? The one who is harmed—then you got the creditors who started lending after they entered into this deepening insolvency.

So, what you are doing is some individual creditors may have standing, and other individual creditors may not have standing based upon the point and time, whether they were in before or after the slide into insolvency. But when you are in a bankruptcy context and you are recovering because of the concept of equal distribution. You are doing it on behalf of everyone.

Hence, there is a real problem there for a trustee stepping into the shoes of the creditor body. In my mind, it really is an individual—if it truly is a cause of action when the duty is owed to creditors, it is the creditors actually harmed by it. And not all creditors are harmed by it.

MR. SWINSON: But have not you just kind of clouded the concept of who has the cause of action and who has standing to bring it?

MR. REICH: I have not clouded it; the courts have. That is where we have been with this whole thing. We have got concepts of—for example, we have got derivative causes of action. Should they be brought in state court as a derivative cause of action?

MR. GOLD: Let me jump in on that. In *Production Resources*,[169] Vice Chancellor Strine struggles with this a little. The opinion suggests that he lacked briefing on some of the questions. He does not resolve all the issues. But his treatment suggests that these kinds of actions would typically be derivative claims because, in Delaware, the idea would be that the fiduciary duty is owed to the corporate enterprise. But then he says—and it is obviously going to depend on the facts—he says, there might possibly exist circumstances in which the directors display such a marked degree of animus towards a particular creditor with a proven entitlement to payment that they exposed themselves to a direct fiduciary duty claim by that creditor. That is always a possibility if the facts would support it.[170]

MR. REICH: That creditor. We see cases all the time, especially—actually quite common in the workout situation. Those of us who do workouts, we are trying to juggle with all these creditors out there. Some play ball with us. And the ones that play ball with us, our clients

169. Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004).

170. *See id.* at 798 (suggesting when a firm is insolvent that "there might, possibly, exist circumstances in which the directors display such a marked degree of animus towards a particular creditor with a proven entitlement to payment that they expose themselves to a direct fiduciary claim by that creditor."). The Delaware Supreme Court has now made clear that individual creditors of an insolvent corporation may not bring direct claims for breach of fiduciary duty against corporate directors. *See* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 103 (Del. 2007).

pay, and they enter into payment arrangements. And there are always those one or two creditors who are just a real horse's—do not put the word down that I was going to say—and what happens is the client sticks it to him, does not pay him, does not play ball with him, and engages in it.

Now part of the workout might even involve getting loans, new additional loans, to pay creditors back, and part of that workout package might be to help this group of creditors who are cooperative, but to exclude the one who is not cooperative.

Well, here is a case where you are going into—you are definitely in the zone of insolvency. You are incurring more debt that may or may not work out. And you are definitely sticking it to another creditor.

So, I mean, it is all over the board. You have got trustees. You have got liquidating trustees. Liquidating trustees have that sort of standing. It all depends on the court's concept and your concept, as you can convey it, of whether this is truly a corporate harm—harm to the corporate entity or a harm to the creditors.

MR. SWINSON: Let's talk about *in pari delicto*. Before we get into that, I want to just say that I think that it is this *in pari delicto* issue that I think makes the standing so important. Because, remember, the *in pari delicto* says that you, corporation, if you have the cause of action regardless who is bringing the claim on your behalf, derivatively, or what have you, you, corporation, have the cause of action and you, corporation, are an inanimate object; you are represented by living, breathing human beings that did the actions that constitute the claims, and that, if you are bringing these actions and you are subject to this *in pari delicto* defense, it is really your fault. I may have messed up, but I would not have messed up if you had not messed up more.

I think it is important who has standing because, clearly, if the corporation brings that, it is obviously more subject to this *in pari delicto* defense; whereas, if the claim—if the creditors themselves have standing to bring the claims for all of these horrible things that were done to them, then it negates, at least to a large degree, the impact of *in pari delicto*.

MR. REICH: But now you are the trustee and you are bringing a deepening insolvency type claim against the board of directors. I mean, how can they assert *in pari delicto* when they were the insiders in the first place who were doing it?

I understand the *in pari delicto* defense if, let's say, you are suing the lawyers or the lenders or those types of defendants. How does that *in pari delicto* stop someone who is an insider, claiming as an insider?

MR. SWINSON: The *Lafferty* case[171] does a wonderful job of—to the extent it is any good at all, it does a wonderful job of explaining how the *in pari delicto* defense works.

And there are two elements to the *in pari delicto* defense. One is that—what it means is that the wrong is going to be imputed to the corporation when two factors are met. One is, when the actions that were done—that are wrong were done in the course of the person's employment. And it is best to conceptualize this in the context of a cause of action against the officers and directors, I think. But—was it done in the course of the person's employment? And, secondly, was it done for the benefit of the corporation? Was it done for the benefit of the corporation? If those two factors are met, then the *in pari delicto* defense applies.

But it gets complicated. It gets complicated because there is an exception to that second prong, and, that is—is that if the person that did all these horrible things was acting in that person's own adverse interest, then it is not going to be considered for the benefit of the corporation. And, therefore, the *in pari delicto* defense does not apply.

But it gets more complicated than that. It gets more complicated than that because what if you have a situation where you have a sole shareholder, which is oftentimes the case in these Ponzi schemes, or if you have a controlling person, somebody that really dominates this entity and is the one that really dictates what is being done regardless of what these other schmucks that call themselves board of directors really think. They just do whatever this one person tells them to do, which is not uncommon. In that event, they have added an exception to the exception called the sole act or exclusion, what I call the sole act or exclusion, and that is if they are acting—if it is the sole person acting for the benefit of this corporation, then the *in pari delicto* defense does apply.

MR. REICH: And, if you result in a pretty inequitable result—

MR. SWINSON: Tell me about it. As I got to thinking about all this, sometimes it gets so confusing, you just like to step back and look at it from a ten thousand feet perspective and say, here is what we got. We got something that is potentially as terrible as a Ponzi scheme, an absolute fraud from the get-go. You got a bunch of victims out there that have lost lots of money. And I have been doing this a long time, and I have never seen a mayonnaise jar full of money. I do not know where

171. Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001).

the money goes, but on all these fraud schemes, it gets spent. There is never a huge bounty that is available for a bankruptcy trustee to go find. It just never exists.

So you got a bunch of creditors out there with a limited pool of assets that the poor schmuck of a bankruptcy trustee has been able to find. There is going to be a minimal distribution to creditors on unsecured claims, but you may have the principals over there. You have no idea of what kind of money they got. And you like to get into their pocket and find out what they have and recover whatever you can.

But if the corporation that owns the claim is subject to the *in pari delicto* defense, what do you do?

MR. GOLD: Again, on the Delaware law side of it, in the *Trenwick* case itself at footnote 132, the court—[172]

MR. SWINSON: It is a long opinion.

MR. GOLD: Yes. But, anyway, that is where it is located dealing with the fraud claim in the case. Strine says, many of the great corporate scandals have involved concerted activity by company advisors and insiders, activity that sometimes harms not only outsiders, but also derivatively the company's innocent stockholders.[173] The doctrine of *in pari delicto* has never operated in Delaware as a bar to providing relief to the innocent by way of a derivative suit.

So that give us some sense of where the Delaware court would probably go on that.

MR. REICH: The last area—we are going to get to you in a second because we are going to open up to questions in a minute.

What do you do to protect yourself against these claims? And let's talk about that for a second. I am going to reel off for you—it is in the materials—a couple of things, but I am going to start with the last one in the materials and turn to Professor Gold on this one—is the concept of exculpatory clauses within your charters, bylaws, Articles of Incorporation, really coming out of that *Production Resources Group* case[174] out of Delaware.

MR. GOLD: Sure. In that case, the court's emphasizing the derivative suit aspect of this area of the law. If you think of the fiduciary duty as a duty that is owed to the corporate enterprise, with the enterprise including the creditors, and if you put aside the exceptional case

172. Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168 n.132 (Del. Ch. 2006), *aff'd sub nom.* Trenwick Am. Litig. Trust v. Billett, No. 495, 2007 WL 2317768 (Del. Aug. 14, 2007).

173. *Id.*

174. 863 A.2d 772.

where there is a sufficiently marked animus with a particular creditor, you are looking at derivative lawsuits.

And in the ordinary derivative suit where it is initiated by a shareholder, a Section 102(b)(7)[175] provision would protect directors from monetary damages claims based on a lack of due care.

And so the issue comes up whether things would be different because creditors are not necessarily a part of the contract that Section 102(b)(7)[176] covers; and the answer here is that if you are look—if you are using a derivative suit, the corporation is a part of that agreement. And since the corporation is treated as a party of interest here, then 102(b)(7)[177] does apply. And so *Production Resources*[178] and *Trenwick*[179] both support the idea that exculpatory provisions would be applicable.

MR. REICH: I wanted to cite real quick language from the *Production Resources*[180] case, which I think really sums up why these exculpatory provisions are good and why you should use them in drafting documents for your clients. And it says that:

> One of the primary purposes of [the statute] is to encourage directors to undertake risky, but potentially value-maximizing business strategies, so long as they do so in good faith. To expose directors to liability for breach of the duty of care, derivative claims of mismanagement asserted by creditors guts this purpose by denying directors the protection of [the statute] when they arguably need it the most.[181]

So that is the language from the court.

Let's talk about some other things that you can do. One is obtain director and officer insurance. That is seems like one of the most obvious things you should have done.

Obtain indemnifications. This one is real critical and comes back to the business judgment rule that we talked about. As you see the countervailing principles of the business judgment rule, document every transaction you do, especially when you are in this insolvency zone; however, that is loosely defined, with evidence justifying it. Keep apprised of due diligence of your company's financial status and act upon it. Professionals, accountants, lawyers, limit your advice, and

175. DEL. CODE ANN. tit. 8, § 102(b)(7) (2006).
176. *Id.*
177. *Id.*
178. 863 A.2d 772.
179. Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168 (Del. Ch. 2006), *aff'd sub nom.* Trenwick Am. Litig. Trust v. Billett, No. 495, 2007 WL 2317768 (Del. Aug. 14, 2007).
180. *Prod. Res.*, 863 A.2d 772.
181. *Id.* at 777.

your opinions particularly in writing and state how you have limited your advice especially when you are being asked to opine with a client with respect to these types of transactions.

If you are a lender, two things: follow your loan documents and do not exert control over the situation. And, particularly, with respect to following your loan documents, you know how we have all seen language when we represent a creditor, we say, by not taking any action, it does not deem it a waiver or something. Sometimes being the good guy, a lender, can get you into more trouble than being a bad guy. Sometimes just following your documents right the way they are and plowing ahead could be the best thing for you in these situations.

I know you had a couple of ideas that you want to throw in, too.

MR. SWINSON: So many of these fact situations involved a situation where, say an officer or director does something that appears to be in the person's own self-interest. So a commonsensical thing to do would be, in the event a decision comes up for the board that could arguably affect your own personal interest or could affect the situation where you serve as a fiduciary in a different capacity, abstain. Just do not vote on that. Just abstain from it so you cannot be blamed for whatever decision was made on that.

And then, also, just remember that if you are going to make a decision subject to the business judgment standard, put some thought and some diligence into obtaining information in order to make an informed decision. And, if you do that and you document your decision and why you did it and why it appeared to be a prudent thing at the time, I think that is the best protection of all. Document.

MR. REICH: To summarize, from a defensive side, first look at whether it even states a cause of action. You have to look at state law to do that, and the body of law and the common law that is developed in your jurisdiction.

Second, you need to look at it from the point of standing as your second big defense.

Third, look at it from the concept of *in pari delicto* as a defense.

Fourth, look at it from the concept of the business judgment rule as a defense. That is the analysis you should take on the defense side.

On the plaintiff's side—the exact opposite. You do the same thing. Kind of look at the jurisdiction where you are at. If you are in a jurisdiction that allows you to do it as an independent cause of action, do it as an independent cause of action. If you are in a jurisdiction that says you have to bring in the support of another tort, that is the way you are going to have to craft your complaint.

Real careful on the plaintiff's side, make sure you have got the right standing and do it that way. And then, see if you got problems with these other defenses as well and how you can overcome it. Look at evidence of violations, failure to document and the business judgment rule, and that is how you approach it.

Any questions? I know you had one.

MR. LOU ROBIN: My question was that—you have done a very good job of doing the whole description, but you keep on focusing on the Ponzi schemes. And I think Ponzi schemes, by nature, have a fraud issue. And the deepening insolvency issue we always address as something added on.

I think the real question or the real problem is the case where you have a company that is just slowly not doing well and falling into deepening insolvency. And, really, where do you see those cases coming out in the future? Do you think the courts will apply the deepening insolvency action to those cases? Do you think they will just say, well, those are the breaks?

MR. SWINSON: The reason I focused on the Ponzi scheme is because it is just the most apparent. But, right now, it appears that the majority of the cases are saying that if deepening insolvency exists, it exists in the context of fraud. It is not going to exist in the context of negligence. And the companies that are out there that just slide into the zone of insolvency because, for whatever reason—we were talking about it at lunch. Somebody has built a better mousetrap, or who knows what might have happened; if you make what appears to be prudent business decisions subject to the business judgment standard, you nevertheless slide into the zone of insolvency, but some decisions you make prove to be improvident, it sure does not seem to me like there ought to be liability under those circumstances.

MR. REICH: Also, Lou, on the follow-up to that, most of the cases I see in the deepening insolvency area arise from fraudulent financial statements.

MR. LOU ROBIN: Those are easier cases. The hard case to me is that a company has gone into insolvency and the board of directors are sitting there saying, if we shut off—if you close it up now, creditors will get eighty cents on the dollar, but our obligation is to shareholders. And if we take this course, maybe we will be successful and there will be equity for the shareholders.

MR. SWINSON: The cases are saying that there is not a duty when you get into the zone of insolvency to shut the thing down. I do not think that is the law.

MR. REICH: I disagree. I think the ones that—you do not have to shut it down, but some of those stronger cases, the really pro-deepening-insolvency cases have said that, yeah, there may be a point where shutting it down is in the better interest of everybody.

MR. LOU ROBIN: If you are saying that you owe an obligation to creditors, do not you owe an obligation to creditors to shut it down at one point in time?

MR. SWINSON: I do not think we are there yet.

MR. LOU ROBIN: Well, that is my question.

MR. REICH: I have a very strict view of the thing. I do not believe in the concept of deepening insolvency. I happen to believe that, under corporate law, you have a duty to maximize the value to the entity. That duty continues, I do not care whether in the zone of insolvency or not. As long as you are no longer—as long as you do not engage in self-dealing and start drawing money out of the company for yourself, and as long as you do not start engaging in fraudulent conveyances which are covered by statute and common laws and whatever, that is about it.

As a creditor, your remedies are—if you are in a contractual setting, like a vendor, you have your contractual remedies and the protections of the fraudulent conveying laws do it. And pretty much nothing more than that.

MR. LOU ROBIN: But if you have an obligation to maximize value and you are sitting there as a board of directors and you say, well, I have two courses I can take. I can take a course where I can realize, at best, ninety percent of the value, that creditors will get paid ninety cents on the dollar and I am hundred percent certain I can do it that way. Or take another course where if I am right, I will double the value of the company, there will be enough money to pay creditors, and equity holders will survive, or no one will get anything if I am wrong.

Which course do you have to take?

MR. REICH: Well, everything comes back to the business judgment rule. For example, you can have—I represent a mall right now. And they are in a lot of trouble. They could have shut the doors down and maybe that would have maximized. But, you know what? If they can drag it along long enough to find that take-out lender, which may require more debt to do it, they keep it open longer, which might now give them the time to find a buyer. If they find a buyer, they might be able to maximize the value for everybody, not just the creditors, but the equity and everything.

So, again, it all falls back to the business judgment rule. If you engage in self-dealing, then, yeah, that is a different story.

MR. LOU ROBIN: In your case, let's say you drag it. You have those two choices. Let's say someone there is willing to buy it out now for ninety percent, but you take your course because you might get a hundred percent plus another hundred percent, but if you are wrong, you are going to get twenty percent.

I mean, I personally think it is your option to take whatever option you want because you owe an obligation to the equity holders. But, you know, if you are saying you owe an obligation to creditors, when is your—when does your obligation really begin? How certain do you have to be of what the outcome is going to be.

MR. REICH: Traditionally a going concern usually has more value than a liquidation value.

MR. SWINSON: Which is the very reason Chapter Eleven[182] bankruptcy exists. And it occurs to me that if you are really in doubt about this, put the thing in Chapter Eleven[183] bankruptcy, propose a plan, and let the creditors themselves vote on it—whether they are ready to tank it or not and take their cents on the dollar, whether they want to try to reorganize the thing.

MR. LOU ROBIN: But if you put it into Eleven,[184] then your obligation is plainly to creditors. Outside of Eleven,[185] your obligation is arguably for equity.

MR. SWINSON: I say that, though, if you are really worried about your risk of not just liquidating it.

MR. LOU ROBIN: My question is not whether you are worried about your obligation or my obligations. How do you think the courts are going to come out on this?

MR. SWINSON: That is the sixty-four thousand dollar question.

MR. REICH: Let's go to Bill.

MR. BILL SCHORLING: I have two observations, and then, one of those will lead to a question.

Be careful when you cite *Exide*.[186] Judge Carey has said that he thought there is a Rule 12(b) motion to dismiss.[187] His view—and if you read the opinion carefully, I think it is borne out in the opinion,

182. 11 U.S.C. §§ 1101-74 (2006).

183. *Id.*

184. *Id.*

185. *Id.*

186. Official Comm. Of Unsecured Creditors v. Credit Suisse First Boston (*In re* Exide Techs., Inc.), 299 B.R. 732 (Bankr. D. Del. 2003).

187. FED. R. CIV. P. 12(b)(6).

his view is that he thought there were sufficient allegations of lender fraud in that case, that it falls squarely still within the *CitX*—and *CitX*, by the way, is how the judges pronounce that opinion. The *CitX* exception[188] was left over *Lafferty*.[189] So be careful when you are citing *Exide*[190] for a broad proposition. Judge Carey has said he does not think that is what it said.

Secondly, the judges—*Trenwick*[191] went on appeal.[192] The reports of the oral argument are that the supreme court focused primarily on the traditional director and officer action issues in the case, standing, because there were issues about the duties of the directors of the subsidiary vis-à-vis the parent and the need for a demand. So we may not get the definitive decision out of the Delaware Supreme Court that everyone hopes for.

But, more interestingly, there is a district court decision recently in a directors and officers case where the judge refused to grant the motion to dismiss on the grounds he is going to wait to see what the supreme court did in *Trenwick*,[193] and a number of the judges are sitting on Rule 12(b)[194] motions waiting for *Trenwick*.[195] He has not denied them, but they were argued nine months ago. There is no decision, and they are waiting for the supreme court in Delaware.

Footnote, the final observation is, in *Lafferty*,[196] the only issue that the parties argued on appeal was standing. And the creditors committee argued deepening insolvency as injury, which gave the creditors standing. No one on the appeal—in the briefing on the appeal argued that deepening insolvency was a separate cause of action. That came from a quote all by itself.

But do you think that deepening insolvency as a concept still has utility in the area of standing?

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188. Seitz v. Detweiler, Hershey and Associates, P.C. (*In re* CitX Corp.), 448 F.3d 672 (3d Cir. 2006).

189. Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001).

190. *Exide*, 299 B.R. 732.

191. Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168 (Del. Ch. 2006), *aff'd sub nom.* Trenwick Am. Litig. Trust v. Billett, No. 495, 2007 WL 2317768 (Del. Aug. 14, 2007).

192. After the Symposium, the Delaware Supreme Court affirmed both the holding and reasoning of the Court of Chancery in *Trenwick*. Trenwick Am. Litig. Trust v. Billett, No. 495, 2007 WL 2317768 (Del. Aug. 14, 2007).

193. *Id.*

194. FED. R. CIV. P. 12(b)(6).

195. *Trenwick*, 906 A.2d 168.

196. Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001).

MR. REICH: I have always found problems with deepening insolvency arising from the standing issue. When I have attacked—when I file motions to dismiss deepening insolvency, I do not even focus—I mean, I do, but I mostly focus on the standing issues because I find you get more traction on this. The judges pick up on it.

It is easier for a judge, Bill, to bite on the standing argument than on this cause of action—whether there is or it is not—because it really is easy to find and pull a case out of this court or that court that says, oh, yeah, there is a cause of action for deepening insolvency.

Of course, none of the courts have ever articulated the elements. I beg any of you to find one that is actually articulated the elements of the cause of action. They are just saying that it exists.

I find, in all these cases, standing is the critical inquiry. Again, like I said, whether you are dealing with creditors committees, liquidating trusts, trustees, derivative shareholder claims, all of them have problems, and you can argue either side on every one of them. You really can. You can argue for standing or against standing in almost every factual scenario that is out there. Anything else?

MR. JACOB SCHUSTER: I am a student, so forgive me if I get some of these issues wrong, but I am wondering if the—

MR. REICH: Do not worry. We get these issues wrong, too.

MR. JACOB SCHUSTER: I am wondering if—and what I am thinking of is in the late 1980s, the Drexel stuff where Drexel would recapitalize businesses with high—issues of high interest debts and basically sell that debt to other businesses—basically minimize, as I understand, his own risk or their own risk.

So what I am wondering is if the issue of—if this theory can be—has legs as far as that goes—as far as the aiding and abetting theory because that is the way I see it as having a lot of applicability. I mean, if you go with the real estate issue, the real estate crash which is going on right now, it is almost attaching more of an emphasis on judgment to the lenders.

I am wondering if you see there being any particular emphasis in the case law moving in that direction?

MR. REICH: You are talking about deepening insolvency as a claim against lenders.

MR. JACOB SCHUSTER: Correct.

MR. REICH: That is what we just talked about with *Exide*[197]—with Bill that he was mentioning. And he says there is limitations on that,

197. Official Comm. Of Unsecured Creditors v. Credit Suisse First Boston (*In re* Exide Techs., Inc.), 299 B.R. 732 (Bankr. D. Del. 2003).

but what I read out of *Exide*[198] was more of a lender liability theory than a deepening insolvency theory. And it is beyond the scope of this seminar, lender liability. We could spend all day on the whole other subject of lender liability.

But when you get to the core concept of lender liability, the case law that is out there basically says that a lender has no independent duty to the borrower. But what happens is when they start engaging in conduct that looks like control, where they start controlling the decisions of the borrower, that is when they get themselves in trouble. Where *Exide*,[199] and cases like that, and where that *Parmalat* case[200] that I mentioned before starts suggesting is when you start crossing that line. You may not have a deepening insolvency theory, but you might tack that on as one of your elements of damages, your measure of damages. That is where that tort arises in the lender liability context. I hope that answers your question.

MR. JOE MARINO: I can understand the concept of a measure of damages, and to raise it to the level of a tort requires duty breach and the resulting damages.

I come up with a fact situation where you have a corporation operating. It loses its principal client or customer, which is eighty percent of its operations. So, in effect, its sales drop down to twenty percent of what they used to be. The officers and directors realize that they are never going to find somebody who wants their product; it is becoming obsolete, and it is weaning off. Their sales are going to go into a debt spiral anyway, or it is in it. But they decide to keep the doors open merely for the purposes of keeping themselves employed.

They are not making any—they are not making any fraudulent acts. They are not making any representations, but they are taking no affirmative action. There is just inaction, omission. So that when you get into a situation like that, they are letting the company operate for another twelve months, fourteen months while they are drawing out salaries, and the creditors are not going to get paid because, at the end, what is left over is pennies on the dollar.

MR. REICH: So you know all my clients.

MR. JOE MARINO: Yes, I did. And I sued them.

But the point is that it seems to me that in a situation like that when you are talking about deepening insolvency, in that scenario, a measure of damages are that had they filed to liquidate the value of the

198. *Id.*

199. *Id.*

200. Bondi v. Bank of Am. Corp. (*In re* Parmalat Sec. Litig.), 383 F. Supp. 2d 587 (S.D.N.Y. 2005).

salaries or the benefits, the car leases that they were enjoying, all the expenses that they were putting through the business for the fourteen months that benefited themselves exclusively to the detriment of creditors would be the measure of damages; but I do not see it unless you take the position that, at that point, they are insolvent and they had a fiduciary duty to creditors to either marshal the assets for the benefit of the creditors and not prefer themselves.

MR. REICH: Joe, why would not that be a fraudulent conveyance?

MR. JOE MARINO: It is not a fraudulent conveyance. In the concept of a fraudulent conveyance, there is no conveyance. All they are doing is maintaining the operation. That is not a fraudulent conveyance.

MR. REICH: Hold on a second. You are talking about a company who is essentially out of business. So they are not doing anything.

MR. JOE MARINO: They are collecting the receivables.

MR. SWINSON: To pay themselves.

MR. REICH: To pay themselves. So the guy while the business was operating, it was a good company, was drawing a hundred thousand dollars-a-year salary?

MR. JOE MARINO: And his wife was drawing fifty thousand dollars.

MR. REICH: Yes, she was drawing her fifty thousand dollars-a-year salary.

MR. JOE MARINO: And the two cars that were leased.

MR. REICH: That is right, the two Bentleys that they had as company cars.

MR. SWINSON: You are familiar with this?

MR. REICH: Trust me. I see this.

MR. JOE MARINO: This is your client?

MR. REICH: This is my client.

And they continue to do it. And a lot of times we advise the clients, you keep paying your W-2s so nothing changes. But you are right, and that is the advice of general habits.

But for a creative recovery theory, I would attack that situation by saying that, yeah, when you are out there drumming up business and doing the things that you do as an active, let's say, CEO and president of the company, you are entitled to a hundred thousand dollars. But when you are sitting on your butt, just collecting the salary and watching television, and you are still drawing the hundred thousand dollar salary, it is no longer reasonably equivalent value and, hence, fraudulent conveyance.

MR. JOE MARINO: But reasonably equivalent value theory goes for sale. There is no sale here. The officers, in that case, the directors will maintain they are operating—they are trying to—they are collecting the receivables.

MR. SWINSON: But aren't you trying—are you trying to make this a fraudulent—actionable as a fraudulent transfer so the creditors will have standing to bring it? Because it is clearly a breach of duty of loyalty.

MR. REICH: To whom?

MR. SWINSON: To the corporation. Sure it is. To sit there and take a salary and not do anything when anybody using their good sense would go ahead and liquidate the thing and pay the pennies on the dollars.

MR. REICH: Fine. It is a breach of duty of the corporation, and the corporation is owned by the husband and the wife.

MR. SWINSON: But that is the issue that I was raising. Who is going to right the wrong?

MR. REICH: To me, the only remedy is you got to attack it as a fraudulent conveyance.

MR. SWINSON: And the reason you want to do that is because the creditors—you know the creditors themselves have standing to do that.

MR. REICH: As a fraudulent conveyance theory, not as a deepening insolvency theory.

MR. JOE MARINO: I do not use any of those theories. I go on a conspiracy to convert the assets for their own benefit to the detriment of creditors—is the cause of action that I bring.

MR. REICH: Tell me why you have a duty to that. Where is your duty as a creditor on that?

MR. JOE MARINO: Where is the standing? You are asking me—

MR. REICH: No, I am beyond standing. I just want to know what the duty is.

MR. JOE MARINO: Well, the duty is, based on various case law, when a corporation is insolvent, the officers and directors are trustees of the assets for the benefit of the creditors.

MR. REICH: So you are back to deepening insolvency.

MR. JOE MARINO: No, it is not. It is not based on deepening insolvency. You can use that in terms of a measurement of damages. That is what I am saying, if you want to raise that issue. But I have not had to over the years; my theory of conspiracy to convert the assets or just general conversion is more than sufficient and breach of fiduciary duty to liquidate for the benefit of the creditors.

MR. SWINSON: Who has standing to bring that conversion?

MR. JOE MARINO: Creditors. And I represent a creditor. Now other creditors may choose not to bring that cause of action.

MR. REICH: How is that conversion? It is a salary. It is a salary.

MR. JOE MARINO: Actually there is case law on this exact case that the court found that this was an act of conversion, in the state court in New Jersey.

MR. SWINSON: Oh, that is New Jersey.

MR. KEN MARCUS: You are offended by Joe's client who just sits back and collects his salary and waits for the business—

MR. REICH: I am not offended. I represent him.

MR. KEN MARCUS: You are offended by the situation where the creditor just sits back and allows things to run out.

What if the debtor recognizes that it will not be easy to replace the eighty percent customer and takes an aggressive marketing stance, buys—invests a condo in Hawaii and is taking out the buyers in his field on golfing junkets to Hawaii. It is an investment in real estate. He is not paying a hotel bill. He is got the capital investment. He is flying out the buyers—

MR. SWINSON: It is a fact question on whether or not those actions are within what a reasonable person would believe the business judgment standard is.

MR. REICH: That is right. And if you want to recover it, you better look to fraudulent conveyance theory.

MR. KEN MARCUS: Every one of these case has to be on a standing alone basis and a fact basis, and you have to decide what is good business judgment, what is negligent, what is gross negligence or what is fraud.

MR. SWINSON: Let me throw this at you guys. Would you buy this? That when you do go in the zone of insolvency, that if you recognize that the business judgment standard applies, that the scrutiny that is afforded those business judgments is stricter as you go towards the zone of insolvency? Would you buy that?

MR. REICH: I would say it is more suspect.

MR. SWINSON: More suspect? Would you buy that?

MR. GOLD: I think it could be. I think that there is also a concern that as things go bad that courts are going be more prone to error. There are tough choices when the company is in a zone of insolvency.

I would suggest, at least in Delaware, the business judgment rule is still pretty robust in that context.

MR. REICH: You know, there is another legal concept that we forget about. We have been talking about business judgment and all. It is the basic concept of corporate law which is, you know, the individuals behind the corporation, the shareholders, the officers and directors, are not liable for the debts of the corporation. And everything we are doing here is trying to find a way to get around that.

MR. JOE MARINO: That is why conspiracy—

MR. REICH: No, but you have to preserve that fundamental concept.

So I again come back to the fact, Joe, you are a creditor, you are a vendor of mine. My business cannot pay you. Tough. That was your bad—this is like Judge Posner. I am back to the old Posner days. You know, listen, it is the economic reality situation. You wanted to protect yourself? Why didn't you get a security interest? Why didn't you get a personal guaranty? That is your problem. You run the risk by dealing with me as an unsecured creditor that I may not be able to pay you something.

MR. JOE MARINO: Well, it is not my fault as a defense if I am making a come back to you that said, you did not act in good faith. There was no honesty-in-fact. You acted in a matter that was intended to frustrate my intended benefit of getting paid by taking the money and using it to pay off that lease for that Bentley, to go on these absurd golf junket trips. The point is—

MR. REICH: You are back to the fraudulent conveyance theory again.

MR. JOE MARINO: I respectfully challenge that theory or maybe I do not particularly see it as a fraudulent conveyance because there is no conveyance. There is no transfer of assets for less than adequate—reasonable equivalent value.

MR. SWINSON: What is the value those employees gave sitting on their duffs?

MR. JOE MARINO: But you see, hold on. You could talk about, well, half of the guys who work for unions, and you could talk about a lot of people getting salaries as to whether or not they are truly earning their salaries.

It is very difficult to do that, and I respectfully will tell you that judges are going to be very skeptical about challenging whether or not there was zero value by the officer and director in taking a salary. If the issue now is that it was excessive, then maybe there is some adjustment, but to say that it is a fraudulent conveyance, by and large, it is not going to be accepted by a judge in the state court—not by a state court judge. Maybe a federal judge might do so, but not a state court judge because they are still working and, as long as they can raise some semblance that they made a good faith effort to try to continue to do sales, even though there are no sales, it is buggy whips that they are selling and the demand is very low for that, then you may have a hard time. You may be able to prevail on the basis that there was zero good effort, good faith on their part.

MR. KEN MARCUS: To take it further, maybe they increased their salaries because they are putting in extra time dealing with financial issues of the corporation.

MR. JOE MARINO: Yes.

MR. SWINSON: They are sitting on their duffs even longer?

MR. JOE MARINO: Taking all this money and scaring me.

MR. LOU ROBIN: Passionate argument by creditors should be paid in every situation, but the problem you have is that you have corporations for a very specific purpose: to limit liability. And the reason you do that is to encourage people to take risks.

And that is what this country is based upon, taking risks. If you did not want Henry Ford to go out there and invent a car and do that, because he was going to take a risk, then we would not have cars.

MR. REICH: That is the language that was cited by *Production Resources*.[201]

MR. LOU ROBIN: That is why you have risks and you have to balance that. No one is encouraging fraud. And I think when there is fraud, we should go after it. But we have to have some semblance here.

MR. SWINSON: Well said.

MR. LOU ROBIN: Thank you.

MR. REICH: No other questions? We thank you.

201. Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004).